No. 13700

In the

United States Court of Appeals

For the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, *Petitioner,*

vs.

RALPH E. HEDGES, *Respondent.*

COMMISSONER OF INTERNAL REVENUE, *Petitioner,*

vs.

STANLEY HEDGES CHILDRESS, *Respondent.*

ON PETITION FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR RESPONDENT, RALPH E. HEDGES

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THE ARGUS PRESS, SEATTLE

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OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 50-61) are reported at 18 T.C. 681.

JURISDICTION

On April 17, 1950, the petitioner, Commissioner of Internal Revenue (hereinafter referred to as "Commissioner"), mailed to respondents (hereinafter referred to as "Taxpayers"), notices of deficiencies in income taxes for the year 1944, for each taxpayer (R. 10-11). The taxpayers filed petitions for redetermination with the Tax Court on June 26, 1950, and July 10, 1950 (R. 3-9), under the provisions of section 272 of the Internal Revenue Code. The petitions were heard on October 9, 1951, in a consolidated proceeding, and the Tax Court entered its decision on August 19, 1952 (R. 64-65). The cases were brought to this court by the petitions for review filed by the Commissioner on November 12, 1952. The jurisdiction of this court rests upon Section 1141 of the Internal Revenue Code as amended by Section 36 of the Act of June 25, 1948.

STATEMENT

There is no real controversy in this case as far as the facts are concerned, and the Commissioner's statement of the case is accurate, except for his indication that four Judges of the Tax Court dissented in the Tax Court's decision. Actually, two judges concurred in the result and two judges dissented (R. 60 and 61).

SUMMARY OF ARGUMENT

The position of taxpayers in this case is that the father, John T. Hedges, held the title to the 7100 shares of Sunshine Mining Company stock for the period 1923 to 1944 in a fiduciary capacity and that John T. Hedges was taxable in that capacity on the dividends declared and paid on the Sunshine Mining Company stock as they were paid during that period. The recovery of those dividends by taxpayers in 1944 was not taxable income except to the extent of the dividends actually paid in 1944, a matter of $710.00 for each taxpayer (R. 53). The dividends had been paid out over a period of years beginning in 1927 and were taxable income in the years in which they were paid, and were not taxable income to anyone in 1944 except as indicated.

As a matter of equity, the Commissioner has not been deprived of revenue because John T. Hedges paid the tax currently on these dividends, as though they were a proper part of his own income at a higher rate than would have been applicable had the fiduciary capacity been disclosed to the Commissioner. As a further matter of equity, it is clear that had these dividends been turned over to the taxpayer as they were paid, they would have had little or no income tax to pay on them because their earnings from other sources were modest, and each had exemptions that would have offset tax liability in most of the years involved.

ARGUMENT

The Tax Court held that John T. Hedges became the administrator of Kittie J. Hedges' estate, and held title to the 7100 shares of stock of Sunshine Mining Company, while acting as a fiduciary; that the probate court ordered distribution of Kittie's estate and discharge of the administrator on October 4, 1924, and that would have probably terminated the administration and settlement of her estate for all purposes had John T. Hedges not intentionally omitted the 7100 shares of stock from the list of assets subject to administration. The Tax Court held that thereafter John T. Hedges necessarily continued to hold the shares in a fiduciary capacity and there was no complete and legal settlement of Kittie's estate until the part thereof which belonged to these taxpayers was turned over to them in 1944, along with amounts equivalent to the dividends on the stock paid during the time it was withheld from their possession by John T. Hedges, the administrator of Kittie's estate. The Tax Court held that these dividends were taxable to some taxpayer when they were received, and that actually that taxpayer was John T. Hedges in his fiduciary capacity. The Tax Court finally held that these amounts were not taxable to the taxpayers when turned over to them in 1944 except to the extent of the dividends actually paid in 1944 under the provisions of section 162 (d) of the Internal Revenue Code. Under that section of the Code, the only income that could be taxable to the taxpayers in the year 1944 would be the amount of the dividends paid on the Sunshine Mining Company stock during the twelve month period preceding August 8, 1944, the date the stock and the back dividends were received from the estate of John T. Hedges. The decision of the Tax Court was entirely correct.

To get a proper understanding of the fiduciary relationship of John T. Hedges in this matter, it is necessary to examine the laws of descent and probate of the State of Washington. There has been no question of the community nature of the Sunshine Mining stock as of the time of Kittie J. Hedges' death. In any event, under Washington law, this stock would have been community property. Any property acquired by either spouse during the existence of a community is presumed to be community property of the spouses, unless it is acquired by gift or devise or descent. *Union Savings & Trust Company v. Manney,* 101 Wash. 274 at 279, 172 Pac. 251.

Under the laws of descent of the State of Washington, in the absence of testamentary disposition, the community interest of a deceased spouse goes to the children of such spouse in equal shares. Revised Code of Washington, Section 11.04.050.

Under the probate laws of the State of Washington, all of the community property is subject to administration in the estate of a decedent. This includes the community interest of the survivor as well as the community interest of the decedent.

Title to the property vests in the executor or administrator, even as against heirs, or devisees or the surviving spouse of the decedent. The Washington Supreme Court in the case of *Bishop v. Locke,* 92 Wash. 90 at page 92, 158 Pac. 997, said:

> "It is the settled law of this state that executors and administrators are entitled to the possession and control of the property, both real and personal, of estates while being administered by them, as against heirs and devisees as well as all other persons."

See also:

> *In re Turner's Estate,* 191 Wash. 145 at 148, 67 P.(2d) 320.

This court has recognized that executors or administrators are entitled to the possession and control of the property under Washington probate law in the case of *Commissioner v. Larson,* 131 F.(2d) 85.

A careful analysis of this case shows that John T. Hedges simply failed to distribute all of the property of the estate of Kittie J. Hedges prior to his death. At the time of his death, there remained the Sunshine Mining Company stock and the dividends paid thereon during the period from 1923 to 1944. This property constituted an undistributed portion of the property of the estate of Kittie J. Hedges, deceased. Section 11.76.250 of the Revised Code of Washington, and its counterpart, Section 1150 of Remington's Revised Statutes of Washington, which was passed in 1917, provides:

> "A final settlement of the estate shall not prevent a subsequent issuance of letters of administration should other property of the estate be discovered, or if it should become necessary and proper from any cause that letters should be again issued."

It is quite clear that taxpayers would have had an action under the above section of the Washington probate law to have the estate of Kittie J. Hedges reopened in 1944, have letters of administration reissued, and the administrator so appointed could then have instituted an action against the estate of John T. Hedges for the 7100 shares of Sunshine Mining Company stock and the dividends paid thereon for the period 1923 to 1944, and the estate of Kittie J. Hedges could then have been again closed and distribution made to the taxpayers herein of their rightful shares in that estate. From a practical standpoint, the same result was accomplished here by the taxpayers filing claims against the estate of John T. Hedges and securing the 7100 shares of Sunshine Mining Company stock and the dividends paid thereon during the period 1923 to 1944, through settlement of those claims.

It would appear that the interests of the taxpayers in this case in the Sunshine Mining stock and the dividends are defined in the case of *Chellew v. White,* 127

Wash. 382, 221 Pac. 3. That case involved the estate of Samuel Chellew, deceased. The decedent left a will leaving the residue of his property to S. C. White, as Trustee and Executor, to be handled and used "as they deem best and to whom they may decide best for the use of orphans and widows whose homes are in the two parishes of St. Ives and Towednack, England, to be expended by them for the relief of worthy orphans and widows of the War with Germany." S. C. White qualified as Executor of the estate and began the administration. The administration was completed and S. C. White, as executor, filed his final account and the property was distributed to S. C. White in trust for use by him as directed by the terms of the Will of Samuel Chellew. S. C. White died the year following the completion of the administration of the estate of Samuel Chellew. His widow, Fannie E. White, filed a petition for her appointment as administratrix *de bonis non* of the estate of Samuel Chellew alleging that there was a certain bank account in a bank in England which had been established by S. C. White to be distributed under the terms of the trust of the will of Samuel Chellew; that this money had not been expended and it was necessary that she be appointed as administratrix *de bonis non* of the estate of Samuel Chellew so that these funds could be administered. The Chellew case involved an action by an heir to establish his inheritance right in the property formerly being administered in the trust by S. C. White, the heir alleging in effect that the administration of the trust terminated on the death of the trustee, S. C. White and that the property reverted to the heirs of the original decedent, Samuel Chellew. The court said at page 396:

> "Contention is made that the right of appellant to have the trust property remaining in the hands of S. C. White undistributed by him at the time of his death, has been finally adjudicated against appellant by the former decree of distribution entered in the probate proceedings, wherein that property was distributed to S. C. White as trustee for use as provided by the will of Samuel Chellew. That, as we view it, was only an adjudication of S. C. White's right to then receive that property, and at his discretion distribute it to certain persons of his choosing. He having failed to so distribute all of that property, and having died with some portion thereof remaining in his hands, as we must assume at this time, such remaining portion simply reverts to and becomes again an undistributed portion of the property of the estate of Samuel Chellew, Deceased. In other words, it is in the same condition with reference to the estate of Samuel Chellew as property of the estate discovered after settlement and distribution, and thereby rendered subject to further administration of the estate of Samuel Chellew, deceased. Section 1550, Rem. Comp. Stat. (F.C. §9812). We conclude that the former decree of distribution does not stand in the way of appellant asserting an inheritance right to this property and his right to the expeditious administration and distribution thereof."

The fact that the heirs of Kittie J. Hedges recovered directly from the estate of John T. Hedges, doesn't change the picture. They would have had the right to have the estate of Kittie J. Hedges reopened for further administration of the non-disclosed assets. But they by-passed the available right and recovered directly from the estate of John T. Hedges. This short-cutting would appear to have been approved in the case of *Griffin v. Warburton,* 23 Wash. 231, 62 Pac. 765, where the court said:

> "But we cannot think a distribution of the property of an estate by an administrator to those to whom the property must ultimately go, made after the debts of the estate and the costs and charges of administration have been paid, is necessarily void because no decree of the court was made directing it. Under the statute as it now exists, the heirs upon the death of the ancestor become vested at once with the full property, subject only to the claims of the ancestor's creditors, and the necessary costs and charges of administration. They have the right of possession against all the world, except the right of the administrator while these claims are being adjusted and satisfied. But the administrator's right to the possession of the property of an estate is temporary, and is limited to the purposes of administration. When the claims of creditors are paid or barred, and the costs and charges of administration are satisfied, the estate is for all practical purposes fully administered upon, the right of possession in the administrator terminates, and the right of the heirs to the residue of the estate in his hands become absolute. The heirs are then entitled to have this residue delivered over to them as their own property, under the law; and it is made the duty of the administrator, by the statute, to surrender the property to them. This duty they can enforce by obtaining a decree of the court directing its performance. As such a decree, however, neither creates their title, nor

their right of possession, to the property, a distribution made without it cannot be invalid. And especially is this so, where, as in the present case, the distributees are of adult age and otherwise competent to contract, and they agree with themselves and with the administrator upon the terms of distribution, and enter into the possession of the property after the distribution is made. The heirs but come into possession of their own property with the consent of the only person who can rightfully withhold possession from them, and they are not to be disturbed in such possession because of informalities in obtaining it."

The fiduciary relationship of John T. Hedges to these taxpayers is clearly indicated by the Washington Supreme Court in the case of *Ryan v. Plath,* 18 Wn.(2d) 839, 140 P.(2d) 968. The court said at page 860:

> "The relation of an administrator to the estate and to those whom he represents is at all times one of trust and confidence and in his dealings with the estate and its assets he acts throughout in a highly fiduciary capacity. He is required to act with utmost good faith in all of his actions and deeds."

The court went on to cite the language of the case of *Stewart v. Baldwin,* 86 Wash. 63, as follows:

> "An administrator stands in a fiduciary relation to those beneficially interested. He is subject to the universal rule that a Trustee is bound to do that which will best serve the interests which for the time are entrusted to his care. His own good faith is not enough."

Again at page 860 of the *Ryan* opinion, the court said:

> "Courts of equity have always scrutinized closely any transaction or series of transactions whereby an administrator or former administrator becomes

> possessed, either directly or indirectly, of property formerly belonging to the estate."

If the position of John T. Hedges was not that of administrator of undistributed assets, he was at least a trustee under a constructive trust and very possibly a trustee under an express trust. Under Washington law the courts have cited with approval the principle that a person occupying a fiduciary relation who has property deposited with him on the strength of such relation, is to be dealt with as a trustee of an express trust. In the case of *Tucker v. Brown,* 199 Wash. 320 at page 330, 92 P.(2d) 221, the court said as follows:

> "An express trust is one created by the act of the parties; and, where a person has, or accepts, possession of money, promissory notes, or other personal property with the express or implied understanding that he is not to hold it as his own absolute property, but to hold and apply it for certain specified purposes, an express trust exists. *Farrell v. Mentzer,* 102 Wash. 629, 174 Pac. 482; 65 C.J. 295; *Allen v. Hendrick,* 104 Ore. 202, 206 Pac. 733.
>
> "A person occupying a fiduciary relation, who has property deposited with him on the strength of such relation, is to be dealt with as a trustee of an express trust. *Moulden v. Train,* 199 Mo. App. 509, 204 S.W. 65."

In any event, this would be a constructive trust under Washington law. In the case of *In re Peterson's Estate,* 12 Wn.(2d) 686 at page 724, 123 P.(2d) 733, the Washington Supreme Court cited with approval the language of Mr. Justice Cardozo in *Beatty v. Guggenheim Exploration Co.,* 225 N.Y. 280, 122 N.E. 378, as follows:

> "A constructive trust is the formula through which the conscience of equity finds expression. When property has been acquired in such circumstances that the holder of the legal title may not in good conscience retain the beneficial interest, equity converts him into a Trustee."

Despite the Commissioner's reference to the language of *Stoddard v. Eaton,* 22 F.(2d) 184, a constructive trust has been recognized under the income tax laws in cases where extreme hardship would arise by failure to recognize equitable principles. See the case of *Knight Newspaper v. Commissioner,* 143 F.(2d) 1007, and the case of *Frederick S. Buggie,* 32 B.T.A. 581.

As indicated in the opening paragraph of the court's opinion in the Tax Court proceedings, the Commissioner in that proceedings relied heavily on the "claim of right theory." Under the "claim of right theory" a person who claims income as a matter of right pays the tax on it at the time the income is realized, and when he is forced to turn the income over to some other claimant, he is allowed a tax deduction in the year he gives the income up. The question then results as to whether or not the new claimant of the income is taxable on it in the year he gets it from one who claimed it as a matter of right, the first claimant, claiming a tax deduction in the year he turned the income over to the second claimant. In this case, it should be kept in mind that there was no income tax deduction claimed by John T. Hedges or his estate when the income on the Sunshine Mining Company stock was given up in 1944. It is true that the dividends on the Sunshine Mining Company stock were eliminated from the estate for estate tax purposes, but the very fact that there was such elimination for estate tax purposes would clearly indicate that there had been no allowance for the deduction for income tax purposes for 1944. Even in the estate tax matter, the dividends were in no sense a deduction —they were simply an exclusion for property that belonged to someone else.

A claim of right situation was before the Tax Court just prior to the Hedges case. It involved facts that were somewhat like those involved here. The case is that of *Virginia H. Vincent,* 18 T.C. No. 40. In that case, the heir sued the corporation that had paid the dividends and recovered from the corporation. The matter had been before the Supreme Court of the State of California in the case of *Hansen v. Bear Film Co.,* 168 P.(2d) 946, and that court had held at page 956 that legal title was in the ancestor pursuant to a transfer by the decedent. In the Tax Court decision, the court commented on the fact that the stock had been held under a claim of right, and the Tax Court held that the heir was taxable on the income when she received it from the corporation that had wrongfully paid it out to another.

The Commissioner appears to have abandoned his claim of right theory in this case in that he indicated at page 11 of his brief that John T. Hedges "was a wrongdoer, a tort-feasor, who not only was under an unqualified duty or obligation to pay over the money to another, but had no semblance of a bona fide claim of right to the money."

The Commissioner had another theory in the Tax

Court proceeding which he is not pressing in this case, and that is that there was a debtor-creditor relationship between the John T. Hedges' estate and the taxpayers, as to the Sunshine Mining Company stock and the dividends paid thereon during the period 1923 to 1944. This theory is likewise mentioned in the opening paragraph of the Tax Court's opinion. As pointed out by the Tax Court in its opinion (R.58), the debtor-creditor theory simply isn't applicable in this case in law or in fact. The taxpayers filed their claim and recovered from John T. Hedges' estate on a fiduciary or trust basis and not on the basis of a debtor-creditor relationship. The Sunshine Mining stock and the dividends paid during the period 1923 to 1944 were not a deduction from the John T. Hedges estate for estate tax purposes, but were simply an exclusion on the basis of tracing specific assets which belonged to someone else and not on a basis of a debtor-creditor relationship. The claim itself shows that the primary object of the recovery was certain Sunshine Mining Company stock that had remained unchanged in form from the date of Kittie J. Hedges' death, and in addition, the exact amount of dividends paid on such stock from the date of Kittie J. Hedges' death to the date of John T. Hedges' death. It is true that there was an alternate claim for a money judgment in the event the stock was not available, but the settlement of the claim was on the basis of awarding to taxpayers stock that had originally been issued prior to the death of Kittie J. Hedges, which still remained in the hands of John T. Hedges and the exact amount of dividends paid on that stock from the date of death of Kittie J. Hedges to the date of death of John T. Hedges.

A claim based on a debtor-creditor relationship has different legal incidents from that based on a trust or fiduciary relationship. This has been demonstrated in a number of Washington Supreme Court decisions. Under Washington law, a creditor's claim has to be filed in a decedent's estate within six months of the publishing of notice to creditors. If a claim is that of a creditor, a failure to file within that six months' period bars the claim forever. If, on the other hand, a claim is filed on a trust or fiduciary basis, then the filing need not be made within the six months' period. The case of *Davis v. Shepard,* 135 Wash. 124, 237 Pac. 21, is a leading case in Washington on this question. In that case the Washington Supreme Court cited with approval the following:

> "In Woerner's American Law of Administration, Vol. 2, §402, it is said:
>
> " 'As between a *cestui que trust* and his trustee the Statute of Limitations does not usually apply; and where a trustee dies, the trust fund if traceable in specie, constitutes no part of his estate, and is recoverable from the administrator by the successor in the trust, or person entitled to the fund, without any of the formalities prescribed for the establishment of a claim against the deceased, and hence the statute of non-claim does not apply to such an action, * * * But when such trust fund is confused with the trustee's own property, so that its identity is lost, the *cestui que trust,* or new trustee, as the case may be, stands in the position of a general creditor, to whom the statute of non-

claim applies with equal rigor as against other creditors.' "

This distinction between a claim based on a trust relationship and a claim based on a debtor-creditor relationship has been discussed in other Washington Supreme Court cases. See *Tucker v. Brown,* 20 Wn.(2d) 740, 150 P.(2d) 104; *Smith v. Fitch,* 25 Wn.(2d) 619, 171 P.(2d) 682, and authorities cited therein.

In this court, the Commissioner advances the theory that "In the instant case, not only had John T. Hedges performed all of his 'ordinary duties pertaining to the administration' on the estate of his deceased wife, but he also had been discharged as administrator by the state court as of October 4, 1924. Thus, it is clear that under Section 29.162-1 of Regulations 111 the period for administration for tax purposes had terminated as of that date. It follows that John did not receive the dividends in question during the period of administration and, thus, that he was not taxable as the administrator of his wife's estate under sections 161 and 162 of the Code."

We think it has been shown that John T. Hedges did have the right to this dividend income as administrator of undisclosed assets of the Kittie J. Hedges estate, and as such, that he was taxable on these dividends when they were paid, and that taxpayers were not taxable on the dividends except to the extent of the dividend paid in the year 1944. In any event, we think the argument of the Commissioner has been answered by the reasoning of the Tax Court in its decision (R. 59). Someone was taxable on these dividends when they were paid out during the period 1923 to 1944. If as a matter of fact, these dividends were not taxable to John T. Hedges as a fiduciary or in any other capacity, then they would have been taxable to taxpayers herein, but not during the year 1944, but during the years in which they were paid, 1923 to 1944. The Commissioner has cited cases in which the administration of an estate was dry and sterile and the courts recognized that there was no reason for keeping the administration open but in those cases, the courts have held that the tax is payable by the heirs at the time the income is earned, even though it is held by the estate beyond the normal time of administration and not distributed until later.

The Commissioner in this court next turns his attention to the proposition that where the claim is for loss of profits, the money or its equivalent recovered upon a judgment therefor in a later year, represents income realized in that year. In support of that proposition, he cites the cases of *United States v. Safety Car Heating Co.,* 297 U.S. 88; *H. Liebes & Co. v. Commissioner,* 90 F.(2d) 932; *Hort v. Commissioner,* 313 U.S. 28; *Mathey v. Commissioner,* 177 F.(2d) 259; and *Durkee v. Commissioner,* 162 F.(2d) 184. These cases for the most part were patent infringement cases that were contingent as to amounts and contested as to ownership until the later years. The court in the *H. Liebes & Co.* decision at page 937, clearly indicates that had the right existed unconditionally in the prior year and had the amount been certain, the amount recovered would have been taxable in the prior year. These cases were really cases of when income is properly accruable where a contingency exists and are distinguishable since here the unconditional right to receive the income in the prior years was either that of the father as a fiduciary or that of taxpayers as heirs of the estate of Kittie J. Hedges, and the amount of the dividend and the amount of the stock was fixed and certain.

CONCLUSION

This court should keep in mind that there is only one question involved in this case and that is, whether or not taxpayers realized taxable income in 1944. It is the position of taxpayers that if taxable income was realized on these dividends, it was realized prior to 1944 except to the extent of the dividends actually paid in 1944, and as far as this proceeding is concerned it is unimportant whether the dividends were taxable to John T. Hedges as a fiduciary or to taxpayers. They were taxable when declared and paid. No one realized taxable income on these dividends in 1944 except to the extent they were declared and paid in 1944. The Tax Court, in a well reasoned opinion, reached a proper result, and their decision should be upheld.

Respectfully submitted,

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